

Internal Revenue Service
Director, Exempt Organizations

Department of the Treasury
P.O. Box 2508 - EP/EO
Cincinnati, OH 45201

Date: JAN 10 2002

Employer Identification Number:
[REDACTED]

Person to Contact - I.D. Number:
[REDACTED] - [REDACTED]

Contact Telephone Numbers

[REDACTED] Phone

[REDACTED] FAX

Dear Sir:

We have considered your application for recognition of exemption from Federal income tax under the provisions of section 501(c)(3) of the Internal Revenue Code of 1986 and its applicable Income Tax Regulations. Based on the available information, we have determined that you do not qualify for the reasons set forth on Enclosure I.

Consideration was given to whether you qualify for exemption under other subsections of section 501(c) of the Code. However, we have concluded that you do not qualify under another subsection.

As your organization has not established exemption from Federal income tax, it will be necessary for you to file an annual income tax return on Form 1041 if you are a Trust, or Form 1120 if you are a corporation or an unincorporated association. Contributions to you are not deductible under section 170 of the Code.

If you are in agreement with our proposed denial, please sign and return one copy of the enclosed Form 6018, Consent to Proposed Adverse Action.

You have the right to protest this proposed determination if you believe it is incorrect. To protest, you should submit a written appeal giving the facts, law and other information to support your position as explained in the enclosed Publication 892, "Exempt Organizations Appeal Procedures for Unagreed Issues." The appeal must be submitted within 30 days from the date of this letter and must be signed by one of your principal officers. You may request a hearing with a member of the office of the Regional Director of Appeals when you file your appeal. If a hearing is requested, you will be contacted to arrange a date for it. The hearing may be held at the Regional Office or, if you request, at any mutually convenient District Office. If you are to be represented by someone who is not one of your principal officers, he or she must file a proper power of attorney and otherwise qualify under our Conference and Practice Requirements as set forth in Section 601.502 of the Statement of Procedural Rules. See Treasury Department Circular No. 230.

[REDACTED]
[REDACTED]

Enclosure I

Facts

You were incorporated pursuant to the nonprofit corporation statutes of [REDACTED] on [REDACTED]. Your Certificate of Incorporation state that the specific purposes for which your corporation is organized are:

"To provide persons, primarily youth, from [REDACTED] area with an appropriate means to enhance their lives and those of their communities by developing, promoting, and governing facilities for and programs of fitness and health activities, especially youth fitness programs, to promote health and educational activities which are related to and flow from such fitness programs and related activities, and to engage in related charitable and educational activities related to the promotion of health and fitness issues."

The Certificate of Incorporation specifies that the original Board of Trustees would consist of three individuals, [REDACTED], [REDACTED], and [REDACTED]. Mr. and Mrs. [REDACTED] are husband and wife. [REDACTED] is the attorney for the corporation.

During a meeting of the Board of Trustees on [REDACTED], [REDACTED] resigned his position on the Board and the following individuals were elected to serve one-year terms on the Board of Trustees: [REDACTED], [REDACTED], [REDACTED], [REDACTED], and [REDACTED].

A draft copy of the bylaws you mailed with your letter dated [REDACTED], states in Article II, section 1.02, that the Board of Trustees shall consist of such number, not less than five nor more than eleven persons. Section 1.10 of the draft bylaws state that a quorum consists of one-half of the entire Board of Trustees. The draft bylaws further state that the Board may appoint an executive committee consisting of the President, the Treasurer, and three or more other Trustees to act until the next annual meeting of the Board of Trustees. During the interval between Board meetings, the Executive Committee may exercise all of the powers of the Board of Trustees. The Executive Committee may also fix its own rules of procedure, but in every case the presence of not less than one-third (but not less than three members) of the Executive Committee shall be necessary and sufficient to constitute a quorum for the transaction of business. Item 2 of the minutes of the special meeting of the Board of Trustees, dated [REDACTED], states that Article II of the bylaws is repealed and is replaced by the following: "...that in no event shall a committee take any action without a majority vote of such committee (excluding the votes of any compensated officer or employee of the Corporation), it being the intention of this Article that disinterested Trustees shall be required at all time to take action for or on behalf of the Corporation."

Part II of the application asserts that the purpose of your organization is to improve the overall fitness level of children. You state you hope to increase public awareness of children's issues by providing scheduled fitness activities that include aerobics, strength training, nutritional awareness, anti-substance abuse seminars, and safety issues seminars. You state your most important program is "[REDACTED]" The focus of this program is to provide fitness and nutritional education to children and their parents. The primary goal is to create fitness and nutrition regiments to be monitored on a weekly basis for children between the ages of 6 and 16, specifically from low-income areas, that have problems such as obesity, ADHD, mild autism, and coordination and concentration challenges. The secondary program is to instruct and train "problem" children in a specific sport, whether the problem is drug-related, violence-related, in foster homes, or adopted. The last program will be to enroll low-income children in fitness activities such as Kung Fu, strength training, hip-hop dance, and others as an after-school activity. These programs will be held at [REDACTED] a for-profit entity from which you took over operations on [REDACTED]. [REDACTED] is owned by Mr. and Mrs. [REDACTED] and offers various fitness programs. These fitness programs, according to your website at [REDACTED] (printed by us on [REDACTED] and sent to you on [REDACTED], include mommy and me, sports conditioning, weight management, kung fu, hung gar, adult fitness, martial arts and aerobics, hip hop, infant massage, soccer camp, cheerleading camp, and parties and more. You did not comment on the website pages we printed.

A description of the activities mailed with information submitted dated [REDACTED] states that the organization's activities include: Cheerleading camp, Hip-Hop, Mommy & Me, Parties & More, Soccer Camp, and [REDACTED]. Cheerleading camp allows members of cheerleading squads to improve their performance and routines for games and competitions. Mommy & Me is a special fitness program for "new" moms in which moms and infants work out together to "get back" into shape and create stronger "mommy/child" bonds. Parties and more allows members to have the option of celebrating parties and birthdays at the center at a low cost to the parents. Non-members can also book the center at a higher cost. Soccer camp is the same as the cheerleading camp except it is designed to improve the skills of those involved in soccer.

A brochure describing the [REDACTED] states that the program operates out of the existing [REDACTED]. The program goals are to instruct children and parents on nutrition, exercise, and fitness to promote overall "wellness". The brochure states that there are many children in need of such programs who are unable to afford membership at this facility. The goal of your organization is to take over the operation of this facility and make it accessible to all children. This program will be entirely funded from contributions and grants. There will be no membership dues.

Membership dues collected from other programs will be used solely for the maintenance of the facility. The [redacted] program operates with five full-time and part-time staff members. These staff members consist of a project director, center coordinator, project evaluator, center assistant, and fitness specialists. The project director and center coordinator are full-time positions with compensation of \$[redacted] and \$[redacted], respectively, while the project evaluator, center assistant, and fitness specialists will be part-time with respective compensation of \$[redacted], \$[redacted], and \$[redacted]. [redacted] occupies the project director position. [redacted] is the center coordinator. The project evaluator will be [redacted]. The center assistant and fitness specialists were not specified.

On [redacted], [redacted] asked to have Form 2848, Power of Attorney and Declaration of Representatives, sent to him so that correspondence and case information could be exchanged with his accountant. A blank Form 2848 was faxed to [redacted]. On [redacted], [redacted] submitted a Form 2848 for your accountant, [redacted] and attorney, [redacted]. The signatures of all parties on this Form 2848 consisted of the first, middle and last initials of each individual. After receiving the Form 2848 sent by [redacted], a conversation was held with [redacted] on [redacted]. [redacted] indicated in this call that he did not sign the Form 2848 submitted by [redacted] on [redacted], but he wanted to submit a Form 2848 so that we could discuss the case. Later, on [redacted], [redacted] indicated that he had signed a Form 2848, but he could not remember what date he had signed the form. Mr. Schwartz indicated in the same conversation that [redacted] was still operating [redacted] but was planning on transferring to a non-profit basis. [redacted] was informed that exemption would not be granted to a for-profit organization. On [redacted], a valid Form 2848 was received from [redacted]. [redacted]'s signature contained his complete first name, middle initial, and complete last name. On [redacted], a valid Form 2848 was received from [redacted] which contained his full signature as first name, middle initial, and last name.

A copy of the long-term lease agreement for your facility was submitted with your correspondence dated [redacted]. The copy of the lease agreement received did not state the landlord's name during any part of the lease. The only signatures on the document were contained on the rider to the lease. These signatures included Mr. [redacted], [redacted], and the landlord's signature. A conformed copy of the lease agreement was requested and subsequently received. The new copy of the lease agreement stated the name of the landlord and contained signatures of the landlord in two different places. The signature of the landlord on the lease agreement first submitted is different from the landlord's signature on the subsequent lease.

The [redacted] letter from [redacted] states, "It is important to set forth the reasons Mr. and Mrs. [redacted] decided to form this non-profit corporation and transfer the assets of [redacted] to it. [redacted] was formed to run the programs described further in the application on a for-profit basis. However, it has struggled to produce a positive cash flow and, frankly, has not produced the volume necessary to make it a profitable business. Mr. and Mrs. [redacted] determined that, because the application did fit into a non-profit, tax-exempt category, the operations might be more successful if the organization could obtain grants and donations, as well as additional publicity, as a tax-exempt organization. Accordingly, the Jacksons formed the new non-profit corporation and essentially transferred the operations to the non-profit corporation as of [redacted]." The [redacted] letter states that "with respect to the differences in operations, the conversion from the for-profit corporation to the non-profit corporation...the daily operations of the business have not changed, except that the purposes are now restricted to those set forth in the Certificate of Incorporation."

The [redacted] budget for the Jackson Foundation for Health and Fitness revealed \$[redacted] in income and \$[redacted] in expenses. Of the total income, \$[redacted] is expected in grants and donations, while the rest of the funding is from fees for services. Employee expenses, including officer compensation, fringe benefits, and payroll taxes, account for \$[redacted] of the total budget. Advertising and marketing expenses total \$[redacted] for the year. The rent for the facility is \$[redacted] for the year.

The current balance sheet submitted on page 9 of your Form 1023 indicated only \$[redacted] cash assets, while the balance sheet for [redacted] indicated both total assets and total liabilities and equity amounted to \$[redacted] as of [redacted]. A balance sheet subsequently submitted on [redacted] for [redacted] reported assets of \$[redacted] and equity and liabilities of \$[redacted] for [redacted]. Your correspondence dated [redacted] your organization stated, "As of [redacted], the operations at the facility switched over to the [redacted], the [redacted] non-profit corporation. As of that date, the balance sheet of the prior corporation was relatively simple. Mr. and Mrs. [redacted] had purchased and contributed to the for-profit corporation a number of pieces of fitness equipment that have been specifically designed for use by children. The aggregate cost of the pieces of original equipment was approximately \$[redacted]. As of [redacted], according to the manufacturers, the approximate value of the equipment transferred between the corporations was \$[redacted]. The remaining current assets and liabilities transferred were relatively minimal. Due to a lack of positive cash flow, no significant cash was contributed...the only significant liability transferred was that of the lease for the premises occupied by [redacted]."

As of [redacted] your organization, a [redacted] non-profit corporation assumed the assets and liabilities of [redacted] a [redacted] for-profit corporation owned by Mr. and Mrs. [redacted]. The document transferring these assets is the "Assignment of Assets and Assumption of Liabilities." [redacted] signed this document for both [redacted] and [redacted]'s wife, [redacted] attested to the document.

Our letter dated [redacted] requested that you submit an appraisal by an independent contractor of the value of the assets and liabilities at the time of transfer. In your letter dated [redacted], you requested a waiver of the appraisal requirement because, "...the existing for-profit business has essentially no net worth; it merely had some equipment and a long-term lease liability." Your organization believes that, "[redacted]'s assumption of that long-term lease liability, as well as its assumption of ongoing business expenses as of [redacted], was sufficient consideration for the transfer of the equipment, and [we] do not believe that an overall appraisal of the business should be necessary given the current financial conditions." This issue was discussed with Mr. [redacted] and Mr. [redacted] several times since the submission of the waiver request. It was conveyed to both Mr. [redacted] and Mr. [redacted] that the waiver would not be granted and that it would be necessary to submit an appraisal to ensure that Mr. and Mrs. [redacted] did not gain private benefit by transferring all assets and liabilities to the [redacted]. Mr. [redacted] subsequently asked whether the Service would accept an appraisal from either an accountant or lawyer. Mr. [redacted] was informed that the appraisal needed to be as specified in the [redacted] letter from an independent, certified appraiser because they are licensed to grant such an appraisal and an attorney or accountant is not.

[redacted] and [redacted] are the only two salaried directors of your organization. Mrs. [redacted]'s salary is \$[redacted] and her duties include responsibility for all aspects of financial operations, marketing functions, review and development of new concepts, procurement of new equipment, head instructor of the [redacted] Program and [redacted], as well as all other duties deemed necessary. Mr. [redacted]'s salary is \$[redacted] and his duties include responsibility for all aspects of day-to-day operations, scheduling and administration of staff, procurement of all supplies and center operational needs, executor of all new programs and activities, maintenance and restoration of equipment and general upkeep of the center, all public relations aspects, and all other duties deemed necessary.

Membership fees with respect to participants according to the information presented in your letter dated [redacted], states that single memberships for silver ([redacted] visits/week) are \$[redacted] per year, gold ([redacted] visits/week) is \$[redacted] per year, weight management is \$[redacted] per year, [redacted]kung fu/Hip-Hop/African Dance/Baby Massage is \$[redacted] per year. The

family membership dues for silver, gold, weight management, and Kung Fu/Hip-Hop/African Dance/Baby Massage are \$[redacted]/year, \$[redacted]/year, \$[redacted]/year, and \$[redacted]/year, respectively. A brochure included with the same letter indicates that membership fees are \$[redacted] per year for bronze membership which entitles the user to [redacted] class per week. Silver memberships are \$[redacted] per year, gold memberships are \$[redacted] per year, weight management is \$[redacted] per year, and open gym is \$[redacted] per year. Personal training is available for \$[redacted] per hour. Family memberships equal the cost of a single membership plus \$[redacted] each month for each additional child. This brochure states, "...[redacted] class sessions are mandatory in order to be eligible for this [open gym] membership." An attachment to the [redacted] letter indicates a financial assistance scale.

Law

Section 501(c)(3) of the Code provides, in part, for the exemption from Federal income tax of organizations organized and operated exclusively for charitable, religious, or educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a) of the Income Tax Regulations provides that, in order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated for one or more of the purposes specified in that section. If an organization fails to meet either the organizational or operational test, it is not exempt.

Section 1.501(c)(3)-1(c)(1) of the Regulations states that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3) of the Code. A single nonexempt purpose, if substantial in nature, will disqualify an organization from qualification under section 501(c)(3).

Sections 1.501(c)(3)-1(d)(1)(ii) of the Regulations asserts that an organization is not operated exclusively for exempt purposes unless it serves a public rather than a private interest. It must not be operated for the benefit of the persons who created it.

In Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 279, the Supreme Court held that the presence of a single non-exempt purpose, if substantial in nature will destroy a claim for exemption regardless of the number or importance of truly educational purposes.

B.S.W. Group, Incorporated v. Commissioner, 70 T.C. 352, denied exemption to an organization created to provide consulting services. The organization offered consulting services at cost to other tax-

exempt and not-for-profit clients as the sole activity. The consulting services were provided to organizations interested in rural-related policy and program development. Individual researchers supplied by the organization to their clients conduct substantive research work. The organization's services are largely intended to be a substitute for full-time staffing of client organizations. The organization charged each client a fee based primarily upon its cost of obtaining paid researchers plus an "administrative" charge. Although the client's ability to pay may be taken into account, the organization's overall fee policy is nevertheless generally to recoup its costs and to realize some profit. Providing managerial and consulting services on a regular basis for a fee is a trade or business that is ordinarily carried on for profit. The fact that services in this case are provided at cost and solely for exempt organizations is not sufficient to characterize this activity as charitable within the meaning of section 501(c)(3) of the Code. The organization could not demonstrate that its own services, or the services performed by its consultants, are not in competition with commercial business such as personnel agencies, consulting referral services, real estate agents, housing rental services, banks, loan companies, trash disposal firms, or environmental consulting companies. These facts indicate that the organization is conducting a business with an apparently commercial character. Therefore, the organization that its primary purpose for engaging in its sole activity is an exempt purpose rather than one of operating a commercial business producing net profits for the organization.

Living Faith, Inc. v. Commissioner, T.C. Memo 1990-484, held that the taxpayer's vegetarian restaurants and health food stores which advocated religious beliefs did not qualify for tax exempt status. The dissemination of literature and information about the Seventh-Day Adventist religious beliefs on diet and health was peripheral and incidental to the substantial commercial purposes of the enterprise. The organization's activities consisted of operating two vegetarian restaurants and health food stores that were open to the public that were operated under the name of Country Life. The meals and food prices were similar to, and in some instances higher than, other restaurants and food stores. The hours of operation are substantially competitive with other commercial enterprises. The promotional materials and literature that Living Faith used were marked with a commercial hue by using commercial catch phrases. For example, some of the literature contained statements such as, "world famous Country Life stores" and, "If you bring this story to our restaurant, we will give you one meal free when you buy one." Profits were used to expand its facilities in order to provide other health programs. These components together indicate that it conducts a business with an apparently commercial character that weighs heavily against exemption.

Revenue Ruling 76-91, 1976-1 C.B. 149 states that when an organization purchases assets from another entity which controls it or with which it has a close relationship, a presumption cannot be made that the

purchase price represents the fair market value. This presumption cannot be determined because the elements of an arm's length transaction are not present. In situations where there is common control of or a close relationship between the buyer and seller and both tangible and intangible assets are being purchased, the value of the tangible assets must first be established by an independent appraisal.

Conclusion

You are similar to the organizations described in the court cases cited above in that even though your stated purpose is charitable, to promote health for children, your operational activity promotes other than charitable purposes.

Your activities promote the private and commercial interests of [REDACTED] as well as the interests of Mr. and Mrs. [REDACTED]. The Tax Court found in Living Faith, Inc. v. Commissioner and in B.S.W. Group, Incorporated v. Commissioner that each organization's activities were commercial in nature. Your organization's operations are also commercial in nature.

B.S.W. Group, Incorporated v. Commissioner states that objective criteria to be analyzed when determining if a substantial nonexempt purpose is present includes, but is not limited to the particular manner the organization's activities are conducted, the commercial hue of those activities, competition with commercial firms, and the existence and amount of annual or accumulated profits.

Mr. and Mrs. [REDACTED] operated [REDACTED] a for-profit fitness center. When your for-profit corporation began operating as a non-profit organization, the daily operations of the fitness center did not change. The hours of operation for your fitness center are similar to other fitness centers for children. Your center is open for classes from 3:30 p.m.-8:30 p.m. Monday through Thursday, 3:30 p.m.-6:30 p.m. on Friday, 2:00-6:00 p.m. on Saturday, and 12:30-3:30 on Sunday. Your center allows members to hold birthday parties at your facility for a specified fee per child. Members receive a discounted rate, while nonmembers may still hold parties at the facility for a higher rate. The fees charged for services are in competition with other commercial fitness centers. The majority of anticipated receipts for your [REDACTED] budget represent fees for services, with \$[REDACTED] of these funds being spent on advertising for your organization. In addition, your brochures, such as the one contain with your letter dated [REDACTED], while stating that you are a non-profit organization dedicated to the improvement of the fitness level of the community's youth, contains some commercial hue by stating that your organization is "the complete health and fitness center for the youth of America." The analysis of your activities and operations indicate that your organization has a substantial non-exempt purpose of operating a commercial venture.

You are not similar to the organization described in Revenue Ruling 76-91 because the elements of an arms length transaction are not present in the assumption of assets and liabilities. The revenue ruling states that in situations where there is common control of or a close relationship between the buyer and seller and both tangible and intangible assets are being purchased, the value of the tangible assets must first be established by independent appraisal. The purchaser must then establish the components of the intangible assets, indicate how these components will be used to further its exempt purposes, and establish the aggregate value of these intangibles.

Accordingly, you do not qualify for exemption as an organization described in section 501(c)(3) of the Code. You are organized for private rather than public purposes within the meaning of section 1.501(c)(3)-1(d)(1)(ii) of the Regulations. You are not operated exclusively for 501(c)(3) purposes because you do not engage primarily in activities that accomplish one of more exempt purposes as specified in section 501(c)(3) of the Code.